STRIKING A NERVE:

ETI's Rejoinder to the NTCA/OPASTCO *False Premises* Report

October 2004

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Preface

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In February, 2004 ETI released a report prepared on behalf of Western Wireless entitled *Lost in Translation: How Rate of Return Regulation turned Universal Service Funding for Consumers into Corporate Welfare for the RLECs,* an analysis of how the present USF funding and regulatory mechanism work to reward inefficient conduct. The report was an exposé of the unintended negative consequences produced by the present well-intended high cost mechanisms. Six months later, NTCA and OPASTCO released a critique of that report prepared by Professor Dale Lehman entitled *False Premises, False Conclusions: A Response To An Attack on Universal Service.* This paper, also prepared on Western Wireless' behalf, represents ETI's response to the misguided criticisms raised in the NTCA/OPASTCO report.

This report was prepared under the overall direction of Lee L. Selwyn, President, Susan M. Gately, Senior Vice President, and Scott C. Lundquist, Vice President. Contributing to the report was Colin B. Weir, Analyst at ETI. The views expressed in this study are those of ETI, and do not necessarily reflect the views of Western Wireless.

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NTCA and OPASTCO have commissioned Prof. Dale Lehman to prepare a response to ETI's February 2004 white paper that reveals gross inefficiencies in the universal service high-cost funding mechanism for rural ILECs ("RLECS"). Lehman's critique mischaracterizes and misreports on several key areas of ETI's analysis. More importantly, however, he appears to have fundamentally misunderstood the paper's primary message. The message of ETI's *Lost in Translation: How Rate of Return Regulation Turned Universal Service Funding for Consumers into Corporate Welfare for the RLECs* is that the present USF funding and regulatory mechanisms "work to reward inefficient conduct" and in so doing deny rural telephone consumers many of the efficiency gains and service improvements that their urban counterparts have come to expect.[1] Contrary to Lehman's characterization, ETI's study was not "An Attack on Universal Service"[2] but rather an exposé of the unintended negative consequences produced by the present well-intended mechanisms.

Each of Lehman's criticisms of ETI's analysis miss the mark.

- Lehman levels the broad criticism that the "premises [of ETI's study] are false, its conclusions do not follow from its analyses, and the conclusions themselves are poor universal service policy." *Nice sound bites* for NTCA /OPASTCO to use when defending the benefits of the status quo for their RLEC members, *but not at all borne out by anything in the Lehman Report.*

- Lehman criticizes ETI's statements that High Cost Fund support to the RLECs has grown beyond any expectations at the time the fund mechanisms were established – from $55-million in 1986 to a projected $3.6-Billion for 2004[3] – claiming that ETI "failed to represent the significant shift from implicit to explicit support."[4] Had Lehman not been

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[1] *Lost in Translation: How Rate of Return Regulation turned Universal Service Funding for Consumers into Corporate Welfare for the RLECs,* Economics and Technology, Inc., February, 2004, at 2.
[2] *False Premises, False Conclusions: A Response To An Attack on Universal Service"* Dale Lehman, August, 2004.
[3] *Lost in Translation*, at 7.
[4] *False Premises*, at 3.

discussing ETI's words completely out of context, he would have been forced to acknowledge that, *in fact, the ETI report specifically analyzed the shift from implicit to explicit support beginning in the very next paragraph.* ETI's report states "Certainly, the FCC has instituted changes that shifted cost recovery from RLEC interstate access charges to the USF High Cost Fund (the LTR, LSS and ICES mechanisms)."[5]

- o After claiming that ETI "failed to represent" the shift from implicit to explicit support, Lehman inexplicably goes on to claim "ETI's analysis of the explicit mechanisms is seriously flawed."[6] *None of the ETI numbers Lehman purports to "correct" in his Table 1 were wrong.* Lehman simply wanted to undertake a completely different analysis, and to do so, he needed different numbers.

- o Lehman claims that growth in the fund should be compared in relation to growth in supported access lines and to the rate of inflation (change in the CPI), but *there is no basis for expecting high cost fund growth to track either of those metrics.* Much of the growth in access lines across the US is accounted for by "second lines" – lines much less expensive to provision than initial lines. Lehman's use of the CPI as a comparison point is even more misguided. The CPI-Telephone index used by the FCC, a somewhat more reasonable gauge, has increased only 10% during the 1989 to 2004 period in which Lehman's CPI increased 52%. Neither of those CPI measures, however, specifically tracks changes in the costs of "producing" telephone services, costs that have been dropping steadily for years.[7]

- o Lehman attempts to discredit ETI's analysis of the extreme variations in RLEC overhead costs (*overhead without sales expenses*), by comparing those results to his separate and distinct analysis of variability of overhead costs across different industries *(inclusive of sales expenses*). As sales expense levels would be expected to vary widely among different industries, it is unsurprising to find extreme variation in overhead expense *inclusive of sales*, across a broad variety of industries. *Lehman's multi-industry Sales, General & Administrative expense data does not refute the credibility of ETI's analysis. It is simply an irrelevant, apples-to-oranges comparison.*

- o Lehman claims that ETI's best-in-class analysis of overheads is flawed, because it focuses on a single year of data and does not aggregate RLEC study areas up to the holding company level. Whether or not a five-year, multi-study area view of overhead expenses would be more realistic, as Lehman contends, the fact remains that RLECs actually are required to report their overhead expenses based on a single year, for

[5] *Lost in Translation*, at 8.
[6] *False Premises* at 3.
[7] The FCC has long recognized that the productivity experienced by companies producing telephone services is greater than that experienced in the economy as a whole, and specifically included a "productivity offset" in its price caps formula for large ILECs.

> individual study areas, and receive support on that basis as well. Thus, ETI's analysis reflects the way the high-cost mechanism actually works. Moreover, Lehman's "correction" to ETI's analysis *supports ETI's conclusion that more efficient consolidation among rural ILECs would be beneficial.*

Attached as an Appendix to this report is a more detailed response to several of the criticisms of ETI's analysis levied by Lehman.

The "real purpose" of ETI's report was to focus attention on the flaws of the present USF system.

When Lehman contends that the "real purpose" of the ETI report is "to divert attention away from a major threat to universal service – the position taken by Western Wireless that wireless carriers are entitled to support levels that are equal to those received by the RLECs,"[8] he demonstrates a fundamental lack of understanding about the objective and core message of ETI's work. The "real purpose" of the ETI report was to focus attention precisely where it needs to be at this crucial juncture – on the massive inefficiencies resulting from the cost-plus mechanism used to calculate the universal service funding subsidy for rural ILECs. ETI's report was intended to focus the attention of the public and regulators on how bloated the demands on the high cost fund had become, based *solely* on the present-day "requirements" of the RLECs themselves (not any new universal service funding for competitive providers). NTCA and OPASTCO can wave their hands all they want to about CETCs being the "major" threat to universal service, but they can't change the indisputable (and still unrefuted) fact that of the $3.3-billion in high cost funding distributed to local phone companies in calendar year 2003, approximately $750-million went to non-rural ILECs, approximately $2.4-billion to RLECs, and merely $131-million ($0.1-billion) to CETCs. Considering that compensation to CETCs accounted for less than 4% of total high cost fund expenditures, even after the CETCs had finally been allotted funding "equal" to the RLECs', [9] there can be no legitimate reason to focus attention on that sliver of the "high-cost pie" when fundamental concerns remain with how support has become so bloated in the remaining 96% of the fund.

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[8] *False Premises* at 1.

[9] It is ironic that after extensively litigated rules were put in place specifically designed to give CETC's high cost funding at a level equal to that of the RLECs they are competing against (so that rural consumer would be able to receive the same benefits of competition as their urban counterparts), the RLECs can still throw their hands up in awe and wonder that CETCs are actually receiving some funds!

APPENDIX: Lehman's criticisms miss their mark

ETI reasonably concluded that the existing regulatory mechanism for high-cost funding does little to "rein in" RLECs who report overhead costs that far exceed those of similarly situated carriers.

ETI's analysis showed that RLECs exhibit extreme variations in overhead costs,[10] even for similarly-sized companies, which cannot be explained solely by differences in the rural territories they serve. We found these variations in the data for all three states we examined (namely, Texas, Ohio, and Wisconsin).[11] We pointed out, for example, that two rural ILECs operating in Texas claimed overhead expenses far higher than the levels reported by other rural ILECs more than three times their size, including ones from the same state (see table below).[12]

Rural ILECs' Extreme Variations in Corporate Overhead Costs

Carrier	Service Territory	Lines Served	Corporate Overheads	OH/Line
Big Bend Telephone Company	Southwest Texas	5835	$3.0-million	$ 514
Valley Telephone Cooperative	Southeast Texas	7042	$2.7-million	$ 383
Etex Telephone Cooperative	Northeast Texas	16565	$2.1-million	$ 127
Hill Country Telephone Cooperative	Southwest Texas	17262	$1.9-million	$ 110

Source: 2002 Earnings Reports filed with TX PUC

From this evidence, we reasonably inferred the existence of inefficiencies in some rural ILECs' operations.[13]

ETI also performed a benchmarking analysis using NECA's most recent USF data submission to the FCC, which encompasses 874 rural ILEC study areas.[14] We used a "best-in-

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[10] ETI defined "overheads" as encompassing Corporate Operations functions (USoA expense accounts 6710-6790), such as executive management, human resources, and administrative support activities, which are not causally attributable to any particular service or customer. (*Lost in Translation* at 33.) The FCC defined overheads in this manner when it set a cap attempting to limit their recovery through the HCF. (See *Lost in Translation* at 35-36, citing May 1997 *Universal Service Report and Order*, 12 FCC Rcd 8776.)

[11] See *Lost in Translation* at 45-49, especially Figure 5.4 ("Small LECs Report Wide Variations in Overhead Expenses").

[12] *Lost in Translation* at 49. All of these four companies operate in rural portions of Texas only, and are not part of a holding company.

[13] *Id.* at 49 and 34-35. The 2003 Texas earnings reports that are now available confirm our findings. In 2003, Big Bend's Corporate Operations expense increased to $3.6-million (while serving 181 fewer lines). Hill Country's 2003 Corporate Operations expense was $2.1-million (while serving 224 more lines). The 2003 Texas earnings reports for Valley Telephone and Etex were filed on a confidential basis and are not publicly available.

class" approach, grouping the study areas by size (line count) and comparing the reported levels of corporate overhead expenses to the best performers within each group (assumed to be the top performing 25 percent). The total amount of claimed expense above those benchmark levels affords an estimate of inefficiently incurred corporate overheads. Out of total corporate overheads of $1.655-billion, some $545.0-million, or 32.9%, were beyond the benchmark level.[15] Thus about one-third of the rural ILEC's claimed corporate overheads expenses are being incurred in an inefficient manner.

In the two sections that follow, we address Lehman's criticisms of our benchmarking analysis (summarized earlier) and show that each of them is without merit.

Lehman's independent analysis of variability in the sales, general & administrative expenses across a broad array of nonregulated industries is irrelevant and in no way disproves ETI's conclusions about the significance of variability in corporate overhead expenses among similarly situated RLECs.

Lehman presents Sales, General and Administrative expenses ("SG&A") for a broad collection of firms operating in nonregulated industries, which "evidence a wide degree of variation," and concludes that this data can "dispel the notion that overhead expenses should be expected to vary little" [16] But Lehman's finding that SG&A expenses vary for nonregulated firms is neither surprising nor relevant. As Lehman admits,[17] SG&A expense is a "broader measure" than the Corporate Operations expenses that the FCC and ETI have used to evaluate overheads, because it "adds the marketing costs" (i.e., Sales) to those Corporate Operations expenses. Nonregulated firms' sales costs can be substantial, and they dominate the aggregate SG&A expense data that he relies upon. For example, in 2003, Microsoft had $8.6 billion in SG&A expense, which comprised nearly half (45.5%) of its total operating expenses of $19.0-billion.[18] However, some $6.5-billion of that amount was sales expense, meaning that Microsoft's corporate overheads, excluding sales, amounted to $2.1-billion – just 11.1% of its total operating expense.[19] By including sales costs in his data, Lehman produces an analysis that bears no direct resemblance to the one presented by ETI and cannot be used to refute ETI's conclusions concerning the significance of extreme variations in corporate overhead costs among similar-sized rural ILECs.[20]

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[14] See *id.* at Chapter 4 ("Benchmarking Analysis Demonstrates RORR-Regulated Rural ILECs Are Operating Inefficiently").
[15] *Id.* at 40.
[16] *False Pr*emises at 9.
[17] *Id.* at 10.
[18] Microsoft Corporation, Form 10-K for the Fiscal Year Ended June 30, 2003 (filed September 4, 2003), at 33.
[19] *Id.*
[20] However, Lehman's use of SG&A data does explain how he is able to reach the erroneous conclusion that the wireless industry, and Western Wireless in particular, have inefficient levels of overheads (*False Pr*emises at 10 and 15-16). As non-regulated carriers operating in competitive markets, Western Wireless and other wireless carriers

Lehman's "correction" of ETI's benchmarking analysis conflicts with how overhead expenses are treated by the High Cost Loop support mechanism, and only serves to underscore ETI's finding of substantial inefficiencies caused by the lack of consolidation among rural LECs.

Lehman criticizes ETI's best-in-class analysis of overheads for focusing on a single year of data, and for not aggregating RLEC study areas up to the holding company level.[21] He proceeds to "correct" the analysis by examining five years of data,[22] and by aggregating study areas to the holding company level.[23] According to Lehman, "[u]se of several years of data can average out some of this variability,"[24] and aggregating by holding company "substantially explains the apparent variability in overhead costs."[25]

In reality, the rules governing high cost loop support require rural LECs to report their costs on a year-to-year and study area basis and make disbursements on that same basis. RLECs are neither required nor allowed to average their loop costs over multiple years, or to aggregate them over multiple study areas.[26] Therefore, even if Lehman's methods conformed more closely to how overhead costs are actually incurred (and it is debatable that they do so),[27] this would only demonstrate that the High Cost Loop mechanism does a poor job of tracking those costs.

Indeed, by showing that the majority of rural ILEC study areas with relatively low overheads (i.e., the "best-in-class" examples) are actually served by RLECs that are part of larger holding companies, Lehman actually corroborates one of our major conclusions, *i.e.*, that further rural ILEC consolidation could substantially reduce rural ILEC cost levels and inefficiencies. Lehman appears to have put on blinders when looking at this issue, for he

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must spend significant amounts of their budgets on sales, marketing, and customer acquisition. Thus, their combined SG&A expense levels will tend to be driven higher by those expenses, even if their Corporate Operations overheads are kept low. For example, in 2002 Western Wireless had total SG&A expenses of $260-million, accounting for 36% of its total operating expenses. However, some $116-million of that amount were for Sales and Marketing; when those expenditures are excluded (as they should be), its overheads (G&A) fall to 20% of total operating expense. (Source: Western Wireless Corporation, Form 10-K for the Fiscal Year Ended December 31, 2003 (filed March 12, 2004), at 37).

[21] *False Premises* at 10-14.

[22] *Id.* at 13 (years 1999-2003, inclusive).

[23] *Id.* at 14.

[24] *Id.* at 13.

[25] *Id.* at 14.

[26] 47 C.F.R. § 36.601 *et. seq.* (2003).

[27] Lehman repeatedly cites to rate case expenses to illustrate "lumpiness" in overheads that he claims ETI did not take into account. See *False Premises* at 7 and 13. However, very few rural ILECs have regular rate cases, and many of those discussed by Lehman (e.g., Big Bend, Five Area, Border to Border, Ottoville) have not had a rate case in the past five years.

declares those benefits "illusory,"[28] at the same time that he takes pains to document that the best-performing study areas (in terms of lowest reported overhead costs) are those associated with holding companies that have implemented precisely those kinds of consolidations.[29] ETI devoted an entire chapter of its report to this issue (see Chapter 3, "RORR-Based Funding Mechanisms Discourage Efficient Consolidation of Study Areas"). As we observed therein:

> Unlike the large ILECs, the rural LECs often avoid the consolidation that would permit them to reduce costs by obtaining larger-scale operations, because any per-line cost reductions they achieve as a result of more efficient operations eventually will result in the reduction of their universal service support.[30]

Strikingly, Lehman argues against consolidation among small rural LECs, claiming it would be "bad for rural America."[31] However, the evidence he has marshaled in support of this conclusion is hardly compelling. For example, while Lehman argues that the jobs provided by rural ILECs are important for rural economic development, the very data he cites shows that those jobs are an insignificant fraction (only 0.5%) of non-metro employment in total,[32] so that any stimulative effect would be minimal. Similarly, his assertion that consolidation would mean "less local customer support" appears to equate on-site personnel with the ability to provide customer support – a curious claim considering that these are telecommunications companies that should be fully able to leverage their communications assets to maintain a local presence, and one belied by the fact that virtually all non-rural ILECs routinely perform their customer care operations (handling of customer inquiries, repair calls, billing and collection, etc.) from highly centralized, regional call centers.[33] Applying Lehman's view of what is "good" for rural America to the banking industry, he would appear to prefer that rural consumers have access only to 9am-3pm walk-in teller service (which creates jobs, after all) instead of the around-the-clock modern ATM banking system that has been developed with consolidation of that industry.

In conclusion, Lehman's attacks on ETI's best-in-class analysis do nothing to undermine our analysis, and in fact help to illustrate just how much the smaller rural LECs are mired in inefficient operations that should not be supported by the nation's consumers through the entrenched universal service mechanisms.

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[28] *False Pr*emises at 13 and 22.
[29] *Id.* at 14.
[30] *Lost in Translation* at 21.
[31] *False Premises* at 20.
[32] *Id.* at 21.
[33] Another example is Valor Telecom, which Lehman chastises for consolidating managerial jobs once it had acquired the Kerrville Telephone Company (*id.*). Valor transferred most customer care functions for Kerrville to its regional call centers in Texarkana, Texas and Carlsbad, New Mexico, and in the process upgraded Kerrville customers' access to include round-the-clock access to account information, the ability to pay bills, report service outages, and track repair progress by phone – while Valor retained the Payment Center location in the Kerrville business office. See Valor's August 6, 2004 press release, "Valor Telecom Announces Consolidation Plans for KTC Business Office and Service Bureau That Will Result in Enhanced Customer Service."

The facts surrounding the operations of the Five Area, West Plains, Border-to-Border, and Ottoville telephone companies highlight the deficiencies in the existing USF mechanisms applied to rural ILECs.

Lehman claims that "the data used in the ETI report is not dependable,"[34] citing alleged errors in ETI's analyses of four RLECs, out of the 140 for which ETI reviewed state-level financial and operating reports.[35] We have reviewed those analyses and find that, other than a labeling problem in one case,[36] ETI accurately reported the data put forth by the RLECs themselves. Thus, the new facts brought to light by Lehman act to reinforce, rather than put to rest, the concerns we expressed about the lack of accountability and public reviewability of the universal service support paid to the nation's RLECs. Each of Lehman's claims concerning these four RLECs are discussed in turn below.

Five Area / West Plains telcos. The fact that the Five Area and West Plains telephone companies are related, as Lehman points out,[37] does nothing to dispel the concerns we raised over the inordinately high levels of corporate overhead expense claimed by many RLECs. Indeed, it begs the question of why, when "Five Area purchased 5 former GTE exchanges" it "creat[ed] West Plains as the subsidiary to operate these [sic]," rather than integrating them into its existing operations. Five Area Telephone Cooperative Inc. provides services in five counties in western Texas.[38] The five exchanges operated by West Plains are all in adjacent areas within these same counties.[39] Indeed, Five Area and West Plains appear to share the same headquarters.[40] The artificial separation of the West Plains affiliate appears to defy any business common sense, particularly where all of the exchanges are in a similar geographic area, the same study area, and where both companies provide similar telecommunications services. This example of an affiliate relationship once again underscores ETI's conclusion that the RLECs have failed to take advantage of consolidation as a means to reduce their per-line operating expenses and overheads.

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[34] *False Premises* at 17.
[35] Those four RLECs are the Five Area, West Plains, Big Bend, and Ottoville telephone companies (*id.*). See pages 45-46 of the *Lost in Translation* report for more details of the set of RLECs for which ETI reviewed financial and operating data filed with state PUCs.
[36] The overheads data we cited for Ottoville Telephone Company actually is for the Champaign Telephone Company, which appears to have been mislabeled during data-sorting. This does not affect our point concerning the amount of variation in corporate overhead expenses among companies of the same size (see *Lost in Translation* at page 48).
[37] *False Premises* at 17.
[38] These are the Baily, Castro, Cochran, Lamb and Parmer counties. (Source: http://www.fivearea.com/Htm%20Files/history.htm, accessed August 26, 2004.)
[39] West Plains serves Earth, Muleshoe, Olton, Springlake, and Sudan; *see Id.*
[40] See http://www.fivearea.com/index.html (Accessed August 26, 2004).

Lehman also claims (without citation to any source) that the year 2002 employee count (*i.e.*, 43 employees) that we attributed to Five Area actually is for Five Area plus West Plains and the parent company's unregulated subsidiaries.[41] However, we have confirmed that we drew the 43 employee value directly from Five Area's work force report to the Public Utility Commission of Texas,[42] which also states that "Five Area Telephone Cooperative, Inc. serves approximately 1,550 access lines in Texas."[43] Thus, the responsibility for any inaccuracy or misleading characterization lies squarely with the telco itself.

Big Bend Telephone Company. ETI documented inconsistencies in Big Bend's financial reports and observed that "Big Bend's 2002 Earnings Report is a good example of how difficult it can be to closely examine these companies for purposes of USF assessment."[44] Whereas Lehman claims (once again, without any citation or other evidentiary support) that "Big Bend received a one-time adjustment of $4,500,000 due to updated investment studies,"[45] none of Big Bend's earnings reports to the PUC of Texas in years 2001, 2002, or 2003 make any mention of such an adjustment. That circumstance alone surely proves ETI's point, and illustrates that existing monitoring by regulators is likely insufficient to prevent abuses.

Moreover, in the course of researching that adjustment, we examined Big Bend's 2003 Earnings Report, and found that it raises additional issues of accountability. In that report, Big Bend states that it had Common Dividends of $12.9-million for 2002, far higher than the $2-3 million range seen in the prior three years[46] – by any measure, a striking payout of profits for a company who receives nearly 40% of its revenues from USF funding.[47] The same report also states that Big Bend incurred a "Hunting Camp Exp[ense]" of $79,999.[48] We continue to believe that regulators have thus far been unable or unwilling to adequately oversee the conduct of rural ILECs such as Big Bend. Such oversight is crucial to ensuring that universal service support is not being diverted from its original purpose of promoting universal access to basic telephone services throughout the country.

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[41] *False Premises* at 17.
[42] See Five Area Telephone Cooperative, Inc., Workforce Supplier and Diversity Form, filed December 19, 2002 (with cover letter from Jarrod Harper), downloaded from PUC of Texas "Interchange" website (http://interchange.puc.state.tx.us), Project No. 26715.
[43] *Id.* (in December 19, 2002 cover letter from Jarrod Harper).
[44] *Lost in Translation* at page 65, footnote 121.
[45] *False Premises* at 17.
[46] Big Bend Telephone's 2003 Earnings Report, Schedule XIV, at line 49.
[47] Lehman has not rebutted our finding that Big Bend receives 37% or more of its revenues from USF payments, and less than 5% from its end user customers. *Lost in Translation* at pages 65-66.
[48] Big Bend Telephone's 2003 Earnings Report, Supplemental Schedule 3.